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TAGS: PGOV ECON EFIN HK CH
SUBJECT: TAX CUT PRESSURE AS NEW BUDGET LOOMS

Classified By: EP Section Chief Simon Schuchat; Reasons: 1.4 (b/d)

## SUMMARY AND COMMENT

¶1. (C) With the next Chief Executive election planned for the first half of 2007, concerns about public acceptance of government revenue and spending policy are playing a heightened role in advance of the unveiling of the 2006-07 budget, which will take place on February 22. Hong Kong's economic performance is expected to be above trend for the third year in a row, and the small budget surplus that emerged last year looks set to be repeated. Consequently, calls are growing among Hong Kong's population for a tax cut. However, Hong Kong's reliance on accumulated surpluses to underpin its currency coupled with a volatile revenue base suggests that any significant revenue cuts offered now might have to be made up later, and in a more painful fashion, during what many believe will be an inevitable downturn -- both cyclical and structural -- in the HKG's fiscal condition. END SUMMARY AND COMMENT

## BUDGET COMING NEXT WEEK

¶2. (SBU) Financial Secretary Henry Tang's February 22 budget speech will likely reveal a small revenue surplus for the second year in a row, thanks to recently strong economic performance -- 8.2 percent GDP growth in 2004 and an estimated 7 percent growth for 2005. Amidst higher interest rates (i.e., higher mortgage payments), it is no surprise that many in the income tax-paying middle and upper classes have taken a look at current trends and decided they would like some money back in the form of a tax cut. There is widespread speculation that Tang will at minimum deliver a one-time tax rebate, and that he may go even further than that.

## LONGER TERM STRUCTURAL CHALLENGES...

¶3. (SBU) While the budget may look flush at first blush, there are underlying structural weaknesses that make a tax cut problematic, given that revenue collections are highly dependent on the economic cycle. The tax base remains narrow here. Income taxes and various fees account for most government revenue, and yields from these sources move up and down with economic performance and property value swings. Further, around 20 percent of fiscal intake comes from highly volatile non-tax sources such as land sales and interest

rate-sensitive returns on accumulated surpluses.

¶4. (C) This unstable revenue environment funds a government that must meet the needs of a society with one of the world's lowest fertility rates, and the aging of the population promises increased health care and social welfare costs over time. Consequently, behind the headlines and editorials calling for tax cuts, there is a quieter agreement among government officials and analysts that Hong Kong will in the longer run need to stabilize its revenue base with a consumption tax (now under consideration) and perhaps fund increasing health care costs with new contributions.

## ... CANNOT BE IGNORED

¶5. (SBU) Surpluses were the norm in Hong Kong until the Asian Financial Crisis, global high-tech downturn, and SARS put government finances under severe pressure after 1997, peaking with a deficit of 6 percent of GDP in the 2001-02 budget. Chronic deficits are a special concern here because an erosion of accumulated fiscal reserves would threaten confidence in the peg of the Hong Kong dollar to the U.S. dollar, which is backed by those surpluses. The necessity of bringing the budget back into balance forced Hong Kong to dig out of its recent deficits in part by reining in expenses, including making painful cuts over the years to civil service employment and compensation.

## A DIFFICULT CHOICE

¶6. (C) Taking all this together, there is a strong case to be made that tampering with cyclical surpluses is a tradeoff between collecting revenue now, when times are good, or



making it up at a more painful juncture in the future, when a downward cycle might well raise the prospect of chronic deficits, forcing a tax hike at an economically painful and politically inopportune time. Given that the HKG is already expected to be forced to strengthen its finances by introducing a consumption tax, any compounding of that sensitive move with a further tax hike or painful expenditure cuts would create significant political tension down the road.

## IMF WEIGHS IN

¶7. (C) The IMF cautioned against cutting taxes this week, and a contact there told us that he hoped coverage of a report released by his organization would help Tang avoid giving in to public pressure. Citigroup Analyst Joe Lo shared with us his research note titled "Candy First, Bitter Pills Later," where he concluded that the HKG probably has some time amidst the strong economic cycle to make small tax cuts and modestly increase expenditures -- but painful fiscal reforms to address public health care and social welfare issues are inevitable.
Cunningham